No. 10352

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

HELM AND SMITH SYNDICATE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S OPENING BRIEF.

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Opinion Below.

The opinion of the Tax Court of the United States, the only previous opinion in this case, was a memorandum opinion and is not officially reported. It appears in the Record before this Court at pages 18 to 21, both inclusive.

Jurisdiction.

This petition for review [R. 226-240] involves federal income taxes for the calendar year 1938. The return in respect of which the question of tax liability arises was filed with the Collector of Internal Revenue at Los Angeles, California. [R. 196.]

On February 6, 1941, respondent mailed a notice of deficiency to petitioners in the amount of $8,885.04. [R. 13-16.]

Within 90 days thereafter and on May 2, 1941 [R. 1], taxpayers filed their petition [R. 3-16] with the Tax Court of the United States for a redetermination of said deficiency as provided by section 272 of the Internal Revenue Code.

The case was submitted to the Tax Court upon a stipulation of all the facts [R. 22-32] on February 4, 1942. [R. 2.]

The decision of the Tax Court [R. 21] sustaining respondent's determination in part, was entered September 10, 1942. [R. 3.]

The cause has been brought to this Court for review by a petition [R. 226-240] filed December 7, 1942, pursuant to the provisions of sections 1141-1142 of the Internal Revenue Code.

Statement of the Case.

Petitioners are a group of unincorporated individuals with a business office at 1704 Chester Avenue, Bakersfield, California, c/o M. J. Davis. [R. 16.] Believing themselves to have organized a partnership or joint adventure, petitioner-group[1] filed an income tax return with the Collector of Internal Revenue on partnership return form 1065, describing their organization as "Helm & Smith Syndicate." [R. 196.]

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[1]Hereinafter, for brevity, referred to as petitioners.

Respondent thereafter determined that petitioners constituted a "corporation" as that term is defined in section 901 of the Revenue Act of 1938 and asserted a liability for corporation income and excess-profits taxes against petitioners for the calendar year 1938. [R. 15.]

Petitioners appealed to the Tax Court of the United States, which upheld respondent's determination that petitioners were a corporation under section 901 of the Act. The Tax Court found, however [R. 20], that because petitioners had subsequently filed a capital stock tax return for the year ended June 30, 1938, the excess-profits tax liability asserted by respondent should be computed by giving effect to the declared value shown therein. As a result of its decision the Tax Court sustained income and excess-profits tax deficiencies against petitioners in the amount of $5,223.57 and $30.73, respectively.

The petition for review and the errors cited therein are directed to the Tax Court's conclusion that petitioners constituted a "corporation" within the purview of section 901 of the 1938 Revenue Act.

All the facts were stipulated. There is, therefore, no controversy as to what the facts *are*. Petitioners contend that the legal conclusions which the Tax Court drew from the facts are erroneous, as a matter of law, and require reversal by this Court.

The facts are as follows:

During 1936 L. G. Helm, believing certain land to have oil possibilities, obtained an option to buy the land at $15.00 per acre from Miller & Lux, Inc., the owners. [R. 22.]

In January, 1937, he contacted eight of his friends and induced each of them to contribute $1,000.00 to be used in purchasing the land. [R. 23.] He gave no receipts for the money so obtained, nor was any formal writing executed specifying the interests of the parties. It was understood, however, that each of the parties was acquiring a one-ninth interest in the property and that Helm would handle it to the common advantage and profit of all. [R. 24.]

Using the monies contributed by the parties, Helm exercised his option to buy the land and entered into a conditional purchasing agreement with Miller & Lux calling for 25% of the purchase price down; annual payments of 10% of the balance, and interest on unpaid balances at 6% per annum. Helm took title to the land in his own name. [R. 24.]

Thereafter he executed sheep grazing leases, covering the property, at twenty-five cents per acre, which he accounted for to the other owners in accordance with their interests. [R. 24.]

Two of the co-purchasers, however, felt that some documentary evidence should be prepared which would disclose the interests of the various parties in the venture. A declaration of trust was prepared and entered into by all of the nine parties under date of June 29, 1937. [R. 25.] This instrument appears in this record at pages 54-65.

Among other things it recited:

1. That Helm, as purchaser, had entered into agreements with Miller & Lux regarding the land. [R. 54.]

2. That whereas Helm in executing said agreements had acted for eight (named) individuals as well as himself,

> "each of such persons purchasing and receiving an undivided one-ninth interest under said contracts and each of said persons paying on account of the consideration * * * an equal one-ninth thereof, and each of said persons now hereby agreeing * * * that they will pay and contribute on account of all future payments required by said contracts and otherwise as hereinafter provided, an equal one-ninth each thereof." [R. 56-57.]

3. That Helm should hold legal title to the property in trust for each of the nine named parties in specified portions with powers "to manage and control the same, to sell, convey, lease, including oil and gas leases, * * * to encumber the same * * *." [R. 57-58.] No power to invest and reinvest the proceeds either of conveyances or leases was granted to Helm.

4. That each of the interest holders "shall provide their proportion of the funds necessary" for the payment of

> "any amount of principal and interest which may become due and payable under the terms and conditions of said [purchase] contracts *and also upon any encumbrances hereinafter placed upon said property including taxes and assessments* * * *." (Italics ours.) [R. 58-59.]

5. No assignment of any interest was to be valid until a written assumption of all obligations of the assignor should be received by the trustee. [R. 60.]

6. A committee of four of the co-owners was to have the power to direct the trustee in the performance of his rights and duties. [R. 60-61.]

No certificates of interest or readily assignable shares were created. [R. 54-63.]

Thereafter Helm executed crop-sharing leases with parties desiring to dry-farm part of the land. [R. 25.]

In January of 1938 Helm called for and received from the co-owners their pro-rata shares of the principal and interest due Miller & Lux upon the purchase contracts. [R. 25-26.]

In May of 1938, Helm negotiated oil leases with five oil companies. Terms were tentatively agreed upon and the agreements deposited in escrow. It was then found that Helm held title under the trust declaration described above. [R. 26-27.]

> "For the purpose of consummating the leasing agreements and of allowing the title insurance policies to be issued without Mr. Helm's being required to perform the usual formalities required of a trustee, the trust declaration was revoked under date of May 24, 1938." [R. 27.]

The leases with the five oil companies were thereupon consummated. From the lessee-oil companies the petitioners received leasing bonuses totalling $29,635.00. [R. 205.]

During this period 451.53 acres of the land were sold outright for a profit of $10,078.30. [R. 204.]

The proceeds of the leases and sales were used to pay off the balance due on the purchase contracts with Miller & Lux, Inc. [R. 28.]

Thereafter the parties executed a second trust declaration under date of July 15, 1938. [R. 29.] This instrument contained substantially the same provisions as the declaration of June 29, 1937, including the assumption by the parties of the obligation to pay the amount of any principal and interest due upon any encumbrances subsequently placed upon the property. [R. 180-195.]

Helm thereafter distributed to each of the co-owners his proportionate share of the monies in excess of what he had used to defray expenses and to pay the balance owing on the purchase price of the land. [R. 29.]

Questions Presented.

The ultimate question before this Court in the instant proceeding is:

Were the rights, powers, privileges and obligations of petitioners of such a character that, as between themselves and outside parties, their organization had the characteristics of the corporate form of business enterprise?

The ultimate question necessarily depends upon the disposition of certain subordinate questions. It is petitioners' position that each of these questions also involves the legal consequences ascertainable from facts which are not in dispute and which therefore present pure questions of law.

The subordinate questions are:

(a) Where all the facts are stipulated and where the issue involves the legal consequences of such facts, is the Tax Court, as a matter of law, privileged to disregard material facts and make no findings upon legal issues

which are necessary elements to a correct determination of the ultimate question?

(b) Where a number of individuals pool their interests in a certain piece of property, with the understanding that one of their number will manage the same to the common profit and advantage of all, and where the liability of each for the obligations incurred by the managing agent is not limited, and where the death or withdrawal of any one of the parties would revoke the authority of the agent to act for him, are they not, as a matter of law, merely co-tenants with a common agent or, at most, joint adventurers?

(c) Where, after pooling their interests in a certain piece of property, a number of individuals, in order to create evidence of their interest therein and to define the rights, powers, privileges and obligations, arising from their relationship, draw an instrument which is, in form, a trust declaration but which (1) does *not* limit the liability of the members to the property embarked in the venture, (2) does *not* create readily transferrable interests, (3) leaves to each member the power to terminate and withdraw, have such individuals, as a matter of law, created anything more than agency relationship, or, at most, a joint adventure?

(d) Where record legal title to property is held in the name of one of the nine co-owners of said property, as managing agent, does such fact constitute, as a matter of law, a basis for ascribing corporate characteristics to the group?

(e) Where the interests of nine individuals in certain land are evidenced solely by a written agreement signed by all and not by any shares of stock, certificates of interest

or participation or the like, and where, as a condition precedent to any valid assignment of interest, the assignee must assume the assignor's obligations to pay the amount of any sums which may have then, or thereafter, become an encumbrance thereon, are the interests of the parties, as a matter of law, divisible and assignable in the manner of corporate stock?

Specification of Errors to be Urged.

In reaching its decision the Tax Court erred in the following respects:

(1) The Tax Court erred in failing and omitting to find from stipulated evidence establishing the same that the rights, powers, privileges and obligations of the nine members of the group were substantially and materially different during the period from May 24, 1938, to July 15, 1938 (during which period no trust agreement was in effect and in which the income here involved was realized) from the rights, powers, privileges and obligations of said members during the portions of the year 1938 in which trust agreements were in effect.

(2) That with respect to the period during which the income in question was realized, namely, the period from May 24, 1938, to July 15, 1938, during which no express trust agreement was in effect as between the members of the group:

(a) The Tax Court erred in failing and omitting to make any finding from the evidence as to the personal liabilities and obligations of the nine members of the group for debts and obligations incurred by Helm in the management of the property.

(b) The Tax Court erred in failing and omitting to find from evidence sufficient to support the same, that during said period the nine members of the group were personally liable for any debts and obligations incurred by Helm in the management of the property.

(c) The Tax Court erred in finding and concluding that during said period the interests of the nine members of the group were divisible and assignable as in the case of corporate stock, and in failing and omitting to find and conclude from the evidence that during said period the interests of the nine members of the group were divisible and assignable only to the extent that the interests of any co-owner of property or partner are divisible and assignable.

(d) The Tax Court erred in failing and omitting to find and conclude from the evidence that during said period any member of the group could have revoked Helm's authority to act for him and could have withdrawn therefrom, and that the death, or assignment of the interest, of any member of the group would have revoked the authority of L. G. Helm to bind such member and that the venture would thereby have been destroyed.

(e) The Tax Court erred in failing and omitting to find and conclude from the stipulated evidence that during said period L. G. Helm held absolute record title to the land owned by the nine individual members of the group, as their managing agent, co-partner or co-adventurer, for the purpose of entering into transactions with respect to which the said members were to share equally the profits and losses therefrom.

(f) The Tax Court's findings and conclusions that during said period the taxpayer-group had substantially the attributes of a corporation are contrary to law.

(3) That with respect to the periods during which express trust agreements were in effect as between the members of the group, namely, the periods from January 1, 1938, to May 24, 1938, and from July 16, 1938, to December 31, 1938:

(a) The Tax Court erred in failing and omitting to find from the stipulated evidence that by express agreement the members of the group had assumed and agreed to pay the amount of any liability for principal and interest incurred by Helm in the performance of his duties.

(b) The Tax Court erred in finding that the interests of the members of the group were divisible and assignable in the form and manner of corporate stock.

(c) The Tax Court erred in failing and omitting to find and conclude from the stipulated evidence that during said periods, any member of the group, as a trustor under the trust agreement, had the power to revoke the trust as to himself and his interest in the property and could have withdrawn from the group.

(d) The Tax Court erred in finding from the evidence that the trust instrument of June 29, 1937, was revoked for convenience in title insurance, and in failing and omitting to find from the evidence that said trust instrument was revoked because the members of the group did not wish to do business pursuant to the terms of said trust.

(4) The Tax Court erred in finding and concluding from the evidence that the fact that title to the property, owned by the members of the group, was held in one name establishes association status.

(5) The Tax Court erred in failing to find and conclude, as a matter of law, that the group was either (1)

a tenancy in common acting through a common agent, or (2) a joint adventure, or (3) a general partnership.

(6) The Tax Court erred in finding and concluding, as a matter of law, that petitioner syndicate was an association like the taxpayer in *Thrash Lease Trust v. Commissioner,* 99 Fed. (2d) 925.

(7) The Tax Court erred in finding and concluding, as a matter of law, that petitioner syndicate had such attributes and characteristics as would bring the group within the definition of an "association" as that term is used in Section 901 of the Revenue Act of 1938.

(8) The Tax Court erred in finding and concluding that there are deficiencies in income and excess profits taxes due from petitioners for the year 1938.

Law Involved.

The instant case arises under the provisions of Section 901(a). The pertinent portion of said section reads as follows:

> "When used in this Act—
>
> * * * * * * * *
>
> "(2) The term 'corporation' includes associations, joint-stock companies, and insurance companies.
>
> "(3) The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation; * * *"

Summary of the Argument.

In cases of this character the issue before the Court is always whether, although in form, a business organization is something else, in substance it has the characteristics (and hence the economic benefits) of the corporate form of organization.

The characteristics which have repeatedly been held by the courts to be those of a corporation are:

1. Title to property embarked in the enterprise held in the name of an entity which continues even though its participants die or assign their interests.

2. Continuity uninterrupted by death or withdrawal of participants.

3. Limitation of liability of participants to property embarked in the undertaking.

4. Creation of shares or certificates of interest assignable as in the case of corporate stock.

5. Centralized management and control of the undertaking.

While state law does not determine whether an organization is a corporation, partnership, trust, or tenancy-in-common for the purpose of classifying it for federal income taxes, the rights, powers, privileges and obligations enjoyed and borne by the members *must* be determined therefrom; for it is from state law that these characteristics stem.

In the instant case the taxable year is divided into two periods: (1) that during which no written agreement was in effect between the participants, and (2) that during which a written agreement was in effect. The income

which is the basis of the controverted tax was realized during the period during which no written agreement was in effect.

During that portion of the taxable year in which no written agreement was in effect the legal relationship of the nine parties had the following characteristics:

1. Legal title to the land owned by the nine persons was held as of record in the name of one of the nine parties, Helm.

2. Helm had authority from each of the other parties to enter into certain leasing and selling agreements relating to the land for the benefit of all.

3. Each of the nine parties would have been bound by any agreement made by Helm, acting within the scope of his authority.

4. Any one or more of the nine parties could have revoked, and the death of any of the nine parties would have revoked, Helm's authority to act for him, since Helm acted solely with their consent.

5. There were no divisible and assignable evidences of ownership which resembled corporate stock, because there were no evidences of ownership in existence at all.

6. The parties did *not,* by agreement or otherwise, limit to the property embarked in the venture their liability for obligations incurred by Helm in the scope of his authority.

Where an organization has the characteristics noted above, it has *none* of the characteristics of a corporation.

During that portion of the taxable year in which a written agreement was in effect, the legal relationship of the parties had the following characteristics:

1. The agreement was, in form, a trust declaration by Helm.

2. The powers bestowed upon Helm were limited to holding, controlling, managing, selling, leasing, conveying and encumbering certain described real property. No authority was granted to invest and reinvest the proceeds of any transactions or to carry on any business other than that relating to the specified powers.

3. Personal liability of the participants was not limited to the property embarked in the venture.

4. No divisible and assignable shares, certificates or other evidences of interest comparable to corporate stock were created.

5. Under the law of California the trust could have been revoked at any time by any member as to his interest. Revocation would have destroyed the continuity of the organization.

Petitioners contend that in neither period of the taxable year were the characteristics of their legal relationship such that, as a matter of law, the group constituted an association as contemplated by section 901 of the 1938 Revenue Act.

REVENUE ACT OF 1938.

Argument.

The Tax Court, in its opinion, states that a "connotative" definition of the statutory term "association" has never been available and that the outline of the term is not clear. [R. 20.] Nevertheless, the Courts on numerous occasions have held that the term "association," as used in the law, connotes certain legal characteristics which must appear if an organization is to be classified as a corporation under the law.

These characteristics were first enumerated in *Morrissey v. Commissioner*[1] by the United States Supreme Court and have been cited many times since in cases involving this issue. This Honorable Court has described them thus:[2]

> "Thus it is said, in substance, that a corporation, as an entity, holds the title to the property embarked in the undertaking; it furnishes centralized management through representatives; it insures continuity of enterprise; it facilitates the transfer of beneficial interests and the introduction of large numbers of participants; and it permits the limitation of personal liability of participants to the property embarked in the undertaking."

In our view of this case, the nature of petitioners' organization prior to May 24, 1938, and after July 15,

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[1] 296 U. S. 344, 56 S. Ct. 289, 80 L. Ed. 263.

[2] *Commissioner v. Gerstle*, 95 F. (2d) 587, 589. See also, *Lewis & Co. v. Commissioner*, 301 U. S. 385, 389, 57 S. Ct. 799, 81 L. Ed. 1174; *Commissioner v. Gibbs-Preyer Trusts Nos. 1 and 2*, 117 F. (2d) 619, 624; *Commissioner v. Rector & Davidson*, 111 F. (2d) 332, 333; *Thrash Lease Trust v. Commissioner*, 99 F. (2d) 925, 928.

1938, is unimportant, although, alternatively, petitioners will demonstrate that during those periods the essential elements of the corporate enterprise were missing, as a matter of law.

It is the character of an organization at the time the income is realized that determines the classification under which that income is to be taxed.

The income under consideration was realized in the interim from May 24, 1938, to July 15, 1938, during which period *there was no written agreement of any kind in effect between the parties.*

The legal consequences of this state of affairs were that while absolute title to the land was in Helm, as of record, the other eight parties were equitable co-tenants with him; that Helm's right to deal with the property required the authority and consent of *each* of the eight other co-owners acting for himself as a principal; that in authorizing Helm to act, each of the eight parties individually appointed Helm his agent; that *each* co-tenant had the legal right and power to terminate the agency at will, regardless of the acts of the other co-tenants, and could have demanded and obtained partition of the property and title to a one-ninth part thereof; that had they desired, one or more of the co-tenants could have discharged Helm as agent and appointed a different agent; that the death, bankruptcy, or incompetency of any co-tenant or of Helm would have terminated the agency as to such co-tenant; that each co-tenant was bound by any acts and personally liable for any obligation incurred by Helm acting within the scope of his authority, and, that if any co-tenant had assigned his interest, the agency, being personal and confidential, would have been terminated.

These features of the relationship of petitioners at the time the income was realized have none of the earmarks of corporate organization. In order to emphasize and clarify these characteristics we will analyze them in the argument which follows by applying the legal tests announced in the *Morrissey* case, *supra,* and followed in principle since that decision.

I.

During the Period in Which No Written Agreement Was in Effect, Petitioners' Organization Had the Legal Characteristics of a Co-tenancy or Joint Adventure.

In a very recent case[1] the U. S. Supreme Court held that although the Board of Tax Appeals[2] is the trier of the facts in cases before it, it must reach its conclusions by applying to such facts correct legal standards and tests.

In the instant case the Tax Court not only applied incorrect legal standards to the stipulated facts but, in some cases, applied no standards at all.

(a) How Legal Title to the Property Was Held.

During this period, legal title to the land was held, as of record, by Helm, absolutely. [R. 28.] Helm was not a trustee under an express written trust *because there was none in existence.* At most he was a constructive trustee by operation of law.

The Tax Court should have found that, as a matter of law, legal title was not held by a continuing entity since

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[1] *Helvering v. American Dental Co.,* No. 303, Oct. Term, 1942, March 1, 1943.

[2] Now the Tax Court of the United States. Section 504, Revenue Act of 1942.

Helm, the individual, was certainly mortal. Had he died or become incompetent, court proceedings would have been required to establish, as of record, the interests of the eight other co-owners in the land. The shareholders of a corporation obviously incur no such hazard and petitioners definitely did not enjoy the benefits of corporate organization in this respect.

The Tax Court said:

> "Title to the property is in one name." [R. 20.]

Such a holding means nothing. Title to property is often in "one name" in situations where an association could not possibly exist. An agent may hold title in his name for the benefit of his principals.[1] A partner may hold title to partnership property in his own name.[2]

It is perfectly apparent that the holding of title by Helm, an individual, was not a correct test of the existence of the corporate form of organization.

(b) Continuity of the Organization.

The Tax Court stated no conclusion regarding this matter although it has always been regarded as one of the essential tests of the corporate form of organization.[3]

During the period in question Helm's authority to sell and lease the property was solely that of an agent or co-partner of the petitioners. His death, or the death of any of the other co-owners, would have revoked his authority to act as a matter of law,[4] and the continuity of the enter-

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[1]*Fleming v. Dolfin*, 214 Cal. 269, 4 Pac. (2d) 776.

[2]California Civil Code, Section 2404.

[3]*Morrissey v. Commissioner, supra*, page 359; *Commissioner v. Gerstle, supra*, page 589.

[4]California Civil Code, Sections 2355, 2356 and 2403.

prise would have been interrupted.[1] Any one of petitioners could have revoked Helm's authority to act for him and could have demanded a conveyance of his interest. Such lack of continuity establishes as a legal proposition the non-existence of the corporate form of organization, for one of the chief elements and benefits of the corporate organization is the immortality of the enterprise regardless of death, whim, or financial condition of its participants.

(c) Character of the Management.

The Tax Court stated:

> "Petitioner is a group collectively engaged in a business enterprise conducted by a central management and control." [R. 20.]

That conclusion is not in accord with the facts. Admittedly every business, corporate or otherwise, must be conducted by someone acting on behalf of the participants. This is as true of sole proprietorships and partnerships as it is of corporations. The term "central management and control" means more than that one partner or an agent is given the power to act for the other partners or his principals.

The test which the Tax Court should have used was whether Helm acted as agent for his co-adventurers or principals, or whether he acted in the manner of corporate officers or directors.

Moreover in the absence of the other controlling features of corporate organization, centralized management

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[1]Assuming Helm was acting as a co-adventurer or partner as distinguished from an agent, his death, bankruptcy, etc., would have dissolved the partnership and revoked his authority to act. California Civil Code, Section 2425.

and control is not sufficient, as a matter of law, to establish corporate or association status.[2]

(d) Transferability of Interests.

The Tax Court held:

> "Participating interests are divisible and assignable." [R. 20.]

This conclusion, as in the case of the others noted above, means nothing as a matter of law. All interests in property of every character are divisible and assignable unless the creator of the interest provides otherwise.

The correct test in cases of this type is whether the interests of the participants are divisible and assignable *in the manner that corporate stock is divisible and assignable.*

In *Commissioner v. Gerstle, supra,* at page 589, this Circuit Court stated the correct legal principle:

> "Their beneficial interests were not readily or conveniently transferable."

The interests of the participants here were created only by an oral understanding between the participants that Helm should execute leases and sales of the property for the common advantage of all. [R. 24.]

As such, the interests of the participants, during the period under consideration, were not evidenced by anything that could have been divided or assigned without the owners' drawing a specific contract to that effect. Nothing analogous to a divisible or assignable share of corporate stock was in existence.

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[2]See *Commissioner v. Gerstle, supra,* page 589; *Commissioner v. Gibbs-Preyer Trusts Nos. 1 & 2, supra,* page 624; *Lewis & Co. v. Commissioner, supra,* page 388; *Commissioner v. Rector & Davidson, supra,* page 333.

To say as the Tax Court did that the interests were divisible and assignable is not only an application of an erroneous legal standard; it is an application of no *standard* at all, since it applies to any number of types of interest and is no legal criterion of the character of the interests of corporate shareholders.

(e) Personal Liability of Participants.

Of all the legal characteristics and advantages of the corporate firm of business organization, none is more vital than the limitation of personal liability of the participants to the property embarked in the undertaking.[1]

In the instant case the Tax Court made no finding regarding this essential matter. It can only be assumed, therefore, that the Tax Court knew that, during the period in question, the parties had *not* so limited their liabilities in connection with the business, and avoided the issue.

In *Planters' Operating Co. v. Commissioner*[2] the Court held that the Board cannot ignore undisputed evidence in reaching its conclusions. It is equally true that the Board cannot ignore stipulated evidence which conclusively establishes, as a matter of law, a factor vital to the determination of the case.

Petitioners during the period in question authorized Helm to enter into certain leasing and selling agreements

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[1] *Cf. Morrissey v. Commissioner, supra,* page 359; *Commissioner v. Gerstle, supra,* page 589; *Thrash Lease Trust v. Commissioner, supra,* page 928.

[2] 255 F. (2d) 583, 585.

on their behalf and respecting property which they owned. [R. 181, first full paragraph.] Since there was no entity standing between them and the parties with whom Helm dealt, which would legally limit their liability, they would have been liable in their own persons and estates for any obligations incurred by Helm in the exercise of that authority. It makes no difference whether Helm acted as their common agent or as the managing partner of a joint adventure, their liability was inescapable.

As a matter of law, therefore, the participants of the organization did not enjoy the primary benefit which corporate organization affords. Having failed to apply a correct legal test to the facts of this case, the Tax Court's decision is erroneous and should be reversed on this ground alone.

Considering all the characteristics of the organization during the period (in which the income in question was realized) it is perfectly apparent that the rights, powers, privileges and obligations of the petitioners are, as a matter of law, indicative of and comparable to a mere co-tenancy with each co-tenant dealing with his interest in the property through a revocable agency. At most, the petitioners constituted a joint adventure. Such elements are the antithesis of the corporate forms and methods required to establish "association" status under Section 901 of the law.

II.

During the Period in Which the Declaration of Trust Was in Effect Petitioners' Organization Lacked the Essential Characteristics of a Corporation or Association Within the Purview of Section 901 of the Revenue Act of 1938.

In reaching a decision the Tax Court admitted that this was "a border line case." [R. 19.] That being so, the Court was under a solemn duty to consider carefully *all* the characteristics of petitioners' organization, for the lack of any essential corporate element would be sufficient to take this organization out of the association classification. This the Tax Court failed to do.

The Tax Court emphasized the fact that the group was "collectively engaged in business." This is not a controlling legal standard, for many types of groups may participate in business enterprises and still not be classified as associations.

In *Commissioner v. Gibbs-Preyer Trusts Nos. 1 & 2, supra,* at page 623, the Sixth Circuit Court analyzed the problem thus:

> "It is not always controlling that one or more persons associate themselves together for the purpose of engaging in business for profit. If Congress had desired or intended to tax every association as a corporation it could have done so easily in simple and unmistakable language and if it had intended such an application of the statutes here in question, it would have so provided. It is persuasive that Congress intended to tax as a corporation *only* associations conducting their business for profit after the method and form of a corporation *with its economic advantages.* The Congress has, in repeated enactments, extended

over many years, provided for the taxation of trusts, partnerships and associations as separate taxable entities." (Emphasis ours.)

It is petitioners' position that their organization cannot, as a matter of law, be said to have had the same characteristics during the period when the income in question was realized (when no trust declaration was in effect) that it had during the period when the trust declaration specified the rights, powers, privileges and obligations of the co-owners. The Tax Court erred in failing to distinguish between these periods.

Nevertheless, assuming that by virtue of some fiction it is argued that the characteristics of the organization were at all times governed by the trust agreement, it is apparent that the essential elements of the corporate form of organization were lacking during the taxable year.

(a) Continuity of the Organization.

The holder of stock has no *power* upon obtaining ownership thereof to demand a distribution of his proportionate share of the corporate assets. In the instant case, each of petitioners had the right to revoke the trust declaration as to his interest and to compel a reconveyance to him of his interest in the land.

It is the law of California[1] that:

"*Unless expressly made irrevocable* by the instrument creating the trust, every *voluntary* trust shall be revocable by the trustor by writing filed with the trustee. When a voluntary trust is revoked by the trustor, the trustee shall transfer to the trustor its full title to the trust estate." (Emphasis ours.)

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[1]California Civil Code, Section 2280.

Provisions specifying the duration of a California trust do not constitute an "express" provision that the trust shall be irrevocable.

In *Fernald v. Lawsten*[1] the trustor transferred her properties and a cosmetics business to Lawsten, as trustee, to pay the income to her for her life, with the remainder over to Lawsten at her death. The trust agreement also provided (as in the instant case) that the trust was to be revocable by an agreement of the parties in writing. The Court held:

> "* * * The trust agreement contains no express provision that it is to become irrevocable. It is expressly provided that the trust shall become revocable when 'agreed upon in writing by the parties thereto.'[2] This does not affirmatively declare the trust may not be otherwise terminated. Since the document is not expressly made irrevocable, it may be revoked in the manner provided by Section 2280 of the Civil Code."

In the instant case, if the petitioners had not intended to reserve the right of revocation to themselves, they would have made an express provision that the trust declaration was to be irrevocable.

No such power to withdraw his share of the assets of the business exists in favor of the holder of corporate shares. It does exist, of course, in the case of co-tenants, partners or joint adventurers.

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[1]26 Cal. App. (2d) 552, 79 Pac. (2d) 742, 746.

[2]Compare the similar provision in the trust agreements here involved. [R. 62 and 191.]

(b) Personal Liability of Participants.

Of all the "economic advantages" which are provided by the corporate form of business enterprise, none is more sought after by the participants than the advantage of limitation of personal liability to the property embarked in the enterprise. The corporate form almost invariably provides it; the trust form usually provides it. But what of the case at bar?

In both declarations of trust the parties expressly agreed to pay *any amount* of principal and interest which might become due upon the purchase contracts and also upon any encumbrances thereafter placed upon said property including taxes and assessments. [R. 58-59 and 187.]

Had Helm in the course of his activities incurred any liabilities or obligations, a judgment thereon would have become a lien, *i. e.*, an encumbrance upon the property. So, also, would tax, assessment, agrarian and mechanics' liens have become encumbrances if liability therefor had been incurred by Helm.

The stockholders of a corporation have the right and privilege of compelling the creditor to look solely to the corporate assets for his due. In the instant case, by their agreement, petitioners deprived themselves of this immunity by agreeing to be personally responsible for such obligations.

Such a legal characteristic is not the mark of the corporate shareholder. It is the mark of the partner or the principal dealing through an agent.

The Tax Court failed even to consider this salient feature of petitioners' organization. In so doing, it erred, prejudicially.

(c) Transferability of Interests.

The Tax Court's finding that "participating interests are divisible and assignable" [R. 20], is, we submit, an insufficient legal standard of any form of business organization.

In alluding to the divisibility and assignability which is characteristic of corporate stock, the courts have used such connotative phrases as "transferable certificates of interest,"[1] and "ready divisibility and transferability of beneficial interests."[2] In other words, the evidence of ownership of corporate stock may be assigned at the will of the holder to another party, who takes it and the interest it represents without incurring any obligation except his obligation to pay the assignor. Neither the corporation nor the other shareholders have any power to prevent the assignment or to attach any conditions thereto. Assignment of stock, in substance, transfers no direct interest in the assets of the corporation but merely a claim against the corporate entity for a share of profits (but not losses) and a right to participate in any liquidation.

The interests of the petitioners bear no similarity to corporate stock, save the feature of assignability which is characteristic of *all* interests in property.

> "There were no shares, certificates, or other evidence of interest beyond each member's copy of the agreement."[3]

Moreover, by express restriction in the agreement, no participant could make a valid assignment of his interest

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[1] *Lewis & Co. v. Commissioner, supra,* page 389.

[2] *Commissioner v. Gerstle, supra,* page 589.

[3] These words, taken from *Commissioner v. Gerstle, supra,* page 589, fit the instant case exactly.

unless the assignee agreed to assume all obligations of the assignor respecting the interest assigned. [R. 60 and 189.] It is not a characteristic of corporate stock that the assignee thereof should assume an obligation to pay a share of any liabilities which might be or become encumbrances upon the corporate assets.

(d) Nature of Petitioners' Organization.

Notwithstanding it conceded this to be a "border line case," the Tax Court, as noted above, failed to consider several of the essential elements which, as a matter of law, are necessary to a finding that an organization is an association under Section 901 of the 1938 Revenue Act.

Without showing any sound legal basis therefor, the Tax Court concluded that petitioners' group was more like the taxpayer in *Thrash Lease Trust v. Commissioner, supra,* than in *Commissioner v. Gerstle,* or *Commissioner v. Rector & Davidson, supra.*

Petitioners hesitate to weary the Court by an extended comparison of these cases but the controlling distinctions involved make that procedure necessary.

1. *Purpose of the Enterprises.*

In the *Gerstle* case and in the instant case, a group of individuals purchased undeveloped real property for the purpose of *selling and leasing* the same for a profit. In the *Rector & Davidson* and *Thrash Lease Trust* cases, groups of individuals acquired undeveloped land for the purpose of carrying on oil drilling operations.

2. *Participating Interests.*

In the *Gerstle, Rector & Davidson* and instant cases, the participants purchased interests in the real property involved, title to which was lodged in trustees for the purpose of facilitating the management of the property. The nature of the ownership was described by this Honorable Court in the *Gerstle* case thus:[1]

> "It seems clear that the members were equitable owners of the real property acquired, and that *their beneficial interests were not merely personal claims against the syndicate managers.*" (Emphasis ours.)

In the *Gerstle, Rector & Davidson* and instant cases, the interest holders owned fractions of the real property and appointed certain ones of their groups, agents or attorneys-in-fact to execute leases, collect proceeds thereof, pay expenses and remit the net proceeds.

In the *Thrash Lease Trust* case, however, participating shares were created and assigned to outsiders whose only interest, in many instances, was a personal claim against the trustee for a share of the profits. Their interests were readily and conveniently assignable in the manner of corporate stock.

In the instant case not only were petitioners' copies of the agreement the sole evidence of their interests, but any assignment required an assumption of personal liability by the assignee which is never found in assignments of corporate stock. (See *ante,* pp. 28-29.)

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[1]At page 590.

3. *Centralized Management.*

In all four cases there was centralized management in the sense that the participants acted through representatives. In all but the *Thrash Lease Trust* case, however, the participants owned direct interests in the land involved and the managers acted as agents of the owner-participants and not as agents of an intervening entity. While there were trustees holding title, their function was essentially ministerial and the actual conduct of the business was performed by the managers.[1]

It was this feature among others that no doubt moved this Honorable Court in the *Thrash Lease Trust* case to remark that "This is a border line case."[2]

4. *Personal Liability of Participants.*

This essential element alone is sufficient to place petitioners well outside the borderline of an association. In the *Thrash Lease Trust* case the Ninth Circuit Court[3] found that the liability of the participants for obligations of the enterprise was limited.

In the *Gerstle* and *Rector & Davidson* cases the Courts both found that the liability of the participants was not thus limited.

In the instant case the Tax Court avoided the issue, but the record is clear that even during the period of the trust agreements, the participants had assumed and agreed to pay the amount of any liabilities which might become an encumbrance on the property.

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[1]In the instant case see the Declaration of Trust. [R. 60 and 189.]

[2]Opinion, page 928.

[3]Opinion, page 928.

The obvious distinctions between the *Thrash Lease Trust* case and the *Gerstle, Rector & Davidson* and instant cases make it perfectly clear that the Tax Court erred in holding that petitioners were more like the taxpayer in the *Thrash Lease Trust* case than the joint adventures involved in the *Gerstle* and *Rector & Davidson* cases.

Conclusion.

1. The Tax Court erred in failing to consider all the elements and characteristics which, as a matter of law, constitute the legal tests to be applied in determining the status of any group as an "association" under Section 901 of the 1938 Revenue Act.

2. During the period in which no trust agreement was in effect, petitioner-group lacked any of the characteristics which, as a matter of law, are necessary to establish that petitioners constituted an "association" under Section 901 of the 1938 Revenue Act.

3. During the period in which the rights, powers, privileges and obligations of the petitioners were specified by the trust declarations their organization lacked the essential elements which are necessary, as a matter of law, to establish that petitioners constituted an "association" under Section 901 of the 1938 Revenue Act.

Respectfully submitted,

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